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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

ESTHER C. DICKMAN AND
ESTATE OF PAUL B. DICKMAN, DECEASED,
G. WENDELL SMITH, PERSONAL REPRESENTATIVE,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

**On Writ of Certiorari
to the United States Court of Appeals
for the Eleventh Circuit**

REPLY BRIEF FOR THE PETITIONERS

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QUESTION PRESENTED

Is a failure to demand repayment of an interest-free demand loan a "transfer of property by gift" subject to the federal gift tax?

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iii
ARGUMENT	1
I. THE IRS HAS FAILED TO DEMONSTRATE THAT CONGRESS INTENDED TO SUBJECT INTEREST-FREE DEMAND LOANS TO GIFT TAXATION	1
A. The IRS Can Point to No Credible Evidence in the Legislative or Administrative History of an Intention to Make Interest-Free Demand Loans the Subject of Gift Taxation	1
B. The "Right to Use" Theory of the IRS Extends Far Beyond the Reasonable Bounds of the Statutory Language	5
II. THE SERIOUS ADVERSE CONSEQUENCES OF ANY JUDICIAL ADOPTION OF THE THEORY OF THE IRS CANNOT EFFECTIVELY BE DENIED	10
APPENDIX (British Capital Transfer Tax)	A-1 - A-9

TABLE OF AUTHORITIES

Cases: Page

Chisholm v. Commissioner, 79 F.2d 14 (2d Cir. 1935), *cert. denied*, 296 U.S. 641 (1935) 11

Commissioner v. Wemyss, 324 U.S. 303 (1945) 3

Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978) 9

Dean v. Commissioner, 35 T.C. 1083 (1961), *nonacq.*, 1973-1 C.B. 4 ..... 6, 7

Gregory v. Helvering, 293 U.S. 465 (1935) 12

Hardee v. United States, 708 F.2d 661 (Fed. Cir. 1983) ..... 6, 7 & 13

Helvering v. Clifford, 309 U.S. 331 (1940) 12

Johnson v. United States, 254 F.Supp. 73 (N.D. Tex. 1966) 6

United States v. Byrum, 408 U.S. 125 (1972) 10

Wells Fargo Bank v. Cory, 110 Cal. App. 3d 242, 167 Cal. Rptr. 778 (1st Dist. 1980) ..... 6 & 12

Zeller v. Zeller, 396 So. 2d 1177 (Fla. App. 1981) 3

Statutes - Federal:

Internal Revenue Code of 1954, as amended (26 U.S.C.):

Section 671 12
Section 2001(b)(1)(B) 16
Section 2035 13
Section 2053 16
Section 2503(b) 16
Section 2511 4
Section 2512 3
Section 6622 16

Revenue Act of 1932, ch. 209 47 Stat. 169 (1932):

§501 3
§503 3

Treasury Regulations (26 C.F.R.):

§ 25.2511-1(h) 4
§ 25.2511-1(h)(4) 4
§ 25.2511-2 4
§ 25.2511-2(c) 5
§ 25.2511-2(f) 5

Revenue Rulings:

Rev. Rul. 77-299, 1977-2 C.B. 343 12
1973-1 C.B. 4 6
Rev. Rul. 73-61, 1973-1 C.B. 408 6

Miscellaneous:

38 C.J.S. *Gifts* §6 3
Dorn, Estate of Hanora C., Brief filed by Estate with Atlanta Appeals Office, Internal Revenue Service on June 30, 1983 12
Finance Act of 1975 § 41 (Great Britain) 14
Finance Act of 1976 §§ 115, 116 (Great Britain) 15
Finance Act of 1981 § 106 (Great Britain) 15
Proposed Amendments to the Finance Act of 1976: Hearings Before Standing Committee E of the House of Commons 799-800 (1981) 15
Proposed Amendments to the Internal Revenue Code of 1954, as Amended: Hearings before the Subcommittee on Oversight of the Internal Revenue Service of the Senate Committee on Finance, 98th Cong., 1st Sess. (1983) (statement of Robert G. Woodward), *reprinted in* Daily Tax Report (BNA) No. 123, J-4, J-7 (June 24, 1983 ..... 9, 11

ARGUMENT

I. THE IRS HAS FAILED TO DEMONSTRATE THAT CONGRESS INTENDED TO SUBJECT INTEREST-FREE DEMAND LOANS TO GIFT TAXATION.

The Commissioner of Internal Revenue (hereinafter "IRS") correctly and at length points out in his Brief that the Congress which enacted the gift tax law in 1932 intended to reach a wide variety of transfers. Brief for the Respondent at 7-15. Despite its best efforts, however, the IRS cannot overcome either of the twin obstacles to its effort to expand by judicial decision the scope of the gift tax: the history of Congressional and administrative action in this area and the less-than-infinite elasticity of the concept of a "transfer of property by gift." For these reasons, the IRS ultimately fails — as it must — to demonstrate that Congress sought to impose gift tax in connection with interest-free demand loans based upon a theory that there is a taxable gift of the "right to use" the sums loaned.

A. The IRS Can Point to No Credible Evidence in the Legislative or Administrative History of an Intention to Make Interest-Free Demand Loans the Subject of Gift Taxation.

Historically, the argument of the IRS rests on nothing more than the breadth of the statutory language, of statements in Committee Reports, and of regulations which largely track either or both. The IRS simply has not directed this Court's attention to any historical reference whatsoever — whether in the gift tax law itself, the legislative history, or regulations — to loans (much less demand loans) as intended subjects of gift taxation. Instead, it must rely on bald assertions that the gift tax is "all-inclusive" and suggestions that any such reference to loans was unnecessary in light of the "broad sweep" of the statute. Brief for the Respondent at 10, 11. The repetition of such general assertions by the IRS, however, serves only to emphasize its

inability to offer any solid evidence that even a single member of the Seventy-second Congress would have concurred in the interpretation of the gift tax statute for which the IRS now contends.

Perhaps more importantly, the argument of the IRS fundamentally misconceives the significance of the use by Congress of broad language in the gift tax law. Such statutory breadth serves the important purpose of precluding future frustration of the tax as a result of the development of novel tax-avoidance techniques which Congress could not foresee at the time of enactment and which might fall outside more narrowly-drawn provisions. The broad terms used in the 1932 gift tax statute were *not* intended, however, to encompass transactions of a kind which were common at the time of enactment, but which would never have been thought by that Congress to constitute "gifts." The loans by the Dickmans were clearly of this description, and the breadth of the statutory language therefore has no significance to the issue before the Court in this case.

The IRS admits, as it must, that interest-free demand loans within families were common features of American life when the gift tax statute now before the Court was enacted. Brief for the Respondent at 14 n.19. Similarly, the IRS makes no assertion that the loans made by the Dickmans were less than *bona fide* in any respect, or were motivated by any desire to lessen or avoid taxes.[1] *See* Pet. A. 22a n.4. Thus, the conclusion is inescapable that the loans at issue in this case were not "novel tax-avoidance techniques," and in fact were no different in kind from those which were common in 1932, or for that matter 1832.

[1]The IRS does suggest that demand loans within families "may have characteristics resembling outright gifts of money," Brief for the Respondent at 25, but retreats from any assertion that the loans at issue in this case were not intended by all parties to be repaid. The reason for the insinuation is apparent: the IRS wants this Court to think of interest-free demand loans as tax-avoidance devices, as "disguised gifts," without bearing the burden of proving that they were used in this manner by the Dickmans. In fact, it is quite clear that the IRS could not meet that burden in this case, where there were substantial loan repayments, where the amounts loaned by Paul Dickman were fully taxed in his estate, and where there is no evidence of any disparity in the marginal income tax rates of the lenders and borrowers.

The Congress which passed the gift tax law now before this Court undoubtedly was aware that parents often loaned their children money or other property without demanding interest. Indeed, it reasonably can be supposed that many members of that Congress had been the recipients of such loans from their parents, and the source of such loans to their children as well. Had that Congress truly intended to subject to the gift tax such a familiar transaction — and one which was so far different from the common, or common law,[2] concept of a "gift"[3] — would it have failed to make even the slightest reference to such an

[2]The Commissioner claims that cases establishing the common law meaning of a "gift" have no relevance here, citing this Court's decision in *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945). Brief for the Respondent at 11 n.14. Because a demand loan is the antithesis of a common law gift — which requires an irrevocable and present divestment of any interest in the property by the donor — the Commissioner's overstatement is not surprising. However, the Court's decision in *Wemyss* plainly did not go so far. The Court there noted that technical common law requirements such as "donative intent" and an entire absence of consideration were inconsistent with, and supplanted by, the "workable external test" of Section 503 of the Revenue Act of 1932, ch. 209 (now I.R.C. § 2512):

> [W]here property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeds the value of the consideration shall ... *be deemed a gift*.... (emphasis added).

The Congress thus implicitly recognized that such transactions might not actually be "gifts" as defined in Section 501 of the 1932 Revenue Act — which levied the tax on "transfers of property by gift" — but nevertheless should be "deemed" as such "for the purpose of the tax imposed by this title."

Thus, where a transaction clearly falls within Section 503, the Congress intended that it should be subject to tax regardless of technical common law requirements, and this Court so held in *Wemyss*. Where, as here, no such conclusion is possible, it cannot be said that the common law is of no relevance. In such instances, the Court must interpret the bedrock statutory phrase of "transfer of property by gift" — a phrase placed in the statute by a Congress which included many fine lawyers well aware of its common law meaning. The common law thus is highly relevant to the determination of Congressional intent in using this phrase, and *Wemyss* clearly does not negate the appropriateness of resort to the common law for this purpose.

[3]"A loan is not a gift; the terms 'to give' or 'to donate' are the precise antithesis of the term 'to loan', which implies a promise to repay or return. An obligation to return or repay the thing received, or to pay interest thereon, or even an expectation of repayment is inconsistent with the theory of a gift." *Zeller v. Zeller*, 396 So. 2d 1177, 1179 (Fla. App. 1981), *quoting* 38 C.J.S. *Gifts* § 6.

intention? The self-evident answer is no, and it is solidly reinforced by the failure of the IRS to seek to impose a tax in connection with demand loan transactions for over thirty years thereafter.

Despite its history of inaction in this area until the 1960's, the IRS makes the remarkable claim that "it was nevertheless reasonably clear from earlier regulations that the gift tax does reach the value conferred by interest-free demand loans." Brief for the Respondent at 14-15. The primary authorities offered for this assertion are the regulations under 26 U.S.C. (hereinafter "I.R.C.") § 2511, 26 C.F.R. (hereinafter "Treas. Reg.") § 25.2511-2. These regulations, however, not only do *not* make it "reasonably clear" that demand loan transactions would result in gift taxation, but strongly indicate the opposite.

The regulations at § 25.2511-1(h) list ten detailed examples of "transactions resulting in taxable gifts." Conspicuous by their absence are examples involving demand loans, or any loans. In each example which does appear, a taxable gift occurs only upon an actual transfer of property, and not upon the mere creation of a "right to use" property which falls short of such a transfer. For example, Treas. Reg. § 25.2511-1(h)(4) discusses the creation of a joint bank account by A for himself and B, upon which either can draw without the consent of the other and without an obligation to account to the other for proceeds drawn from the account. In such an instance, B plainly has the right to draw out all funds in the account at any time and invest them at a market rate of interest. Despite this "right to use" the funds, a taxable gift occurs only when B actually draws such funds out of the account and only "to the extent of the amount drawn." Even if B has allowed the funds to remain in a non-interest-bearing checking account for years, the amount of the gift is to be determined by the amount actually received by B, and not by an amount which B theoretically had the "right to use."

Similarly, Treas. Reg. § 25.2511-2(c) makes it clear that a transfer by gift is incomplete, and therefore not taxable, "in every instance in which a donor reserves the power to revest the beneficial title to the property in himself." In such instances, a taxable gift occurs only if and to the extent that there is actual "receipt of income or other enjoyment of the transferred property" by another. Such a gift is deemed to have been made "as of the calendar quarter or calendar year of its receipt." Treas. Reg. § 25.2511-2(f). Although these provisions are offered by the IRS in support of its contention, Brief for the Respondent at 12-13, they in fact provide strong evidence against it. The regulation — like the gift tax statute itself — is concerned with actual *receipt* of money or other property as a result of a transfer, not imputed values of a "right-to-use" which may or may not be exercised. If such a theory had been envisioned as a part of the law by the framers of the regulations, it is inconceivable that they would have used the language which they did, or that they would have omitted any mention of that theory or of interest-free loans, as in fact occurred. Thus, the regulations strongly negate the disingenuous contention of the IRS that it was always "reasonably clear" that interest-free demand loans were subjects of gift taxation.

B. The "Right to Use" Theory of the IRS Extends Far Beyond the Reasonable Bounds of the Statutory Language.

The truth is that the argument of the IRS in this case has nothing to do with actual Congressional intent. It represents instead an attempt to write into the gift tax law the economic concept of the "time-value of money," and the corollary idea that the mere opportunity to invest or otherwise use money — whether or not exercised — itself constitutes "property" and should be the subject of gift tax. The "time-value" concept is, of course, one which has become increasingly familiar to many Americans in the inflationary economy of the last two decades. Indeed, the position of the IRS might make sense to the Congress

of the 1980's in terms of economics, equity, and tax policy — or it might not. Until it is presented to Congress, no one can safely predict the outcome. But one can state with confidence that this "time-value" concept was no part of the intellectual currency of the Seventy-second Congress, and was not incorporated in the term "transfer of property by gift" as used by that Congress.[4]

In making that statement, it is not necessary to rely alone on the statute and its legislative and administrative history, however compelling they may be. One can also consider the history of the efforts of the IRS to write a comparable concept into the income tax law with respect to interest-free loans in cases ranging in time from *Dean v. Commissioner*, 35 T.C. 1083 (1961), *nonacq.*, 1973-1 C.B. 4, to the recent decision of the Court of Appeals for the Federal Circuit in *Hardee v. United States*, 708 F.2d 661 (Fed. Cir. 1983). In the income tax area as well as the gift tax area, the IRS first began asserting its current position in the 1960's, has relied heavily on the breadth of the applicable statute in the absence of specific language supporting its contention, and has sought to impose a tax on the basis of an imputed benefit irrespective of whether or not actual money or property has been earned through use of the money loaned.[5] In each instance from *Dean* to the present, the courts ultimately have rejected the IRS position. *Cf. Wells Fargo Bank v. Cory*, 110 Cal. App. 3d 242, 167 Cal. Rptr. 778 (1st Dist. 1980)

[4]One illustration of the inconsistency between the gift tax statute as written and the "time value" economic concept is presented by the insistence of the IRS that it is "quite logical" to tax a twenty-year interest-free loan of money as a greater "gift" than an outright gift of the same amount. Brief for the Respondent at 40. The IRS can make this argument only by discounting the supposed value of the "right to use" the money loaned to the date of the initial loan — a date when the IRS admits no "gift" was made under the statute as written. *Id.* at 13. The IRS must also, of course, ignore the common-sense reality that any person offered the choice of an outright gift of $100 or a twenty-year loan of $100 would have no difficulty in determining that the former alternative presented the greater opportunity.

[5]The IRS also acted in the same year both to state its non-acquiescence in *Dean*, 1973-1 Cum. Bull. 4, and to reject, in Rev. Rul. 73-61, 1973-1 C.B. 408, the rationale of *Johnson v. United States*, 254 F.Supp. 73 (N. D. Tex. 1966).

(holding that interest-free demand loans do not result in "transfers by gift" under California gift tax statute).

The conclusion of the court in *Hardee* is highly relevant to the issue before this Court:

> From the inception of our modern income tax laws in 1913 until *Dean* in 1961, the treasury never took the position that an interest-free loan by a corporation to its shareholder-officers resulted in the realization of income. During this period, the Internal Revenue Code has defined income in broad and sweeping terms, yet the government did not see fit, either in litigation or by rule, regulation, or administrative practice, to treat such loans as a taxable event.
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> • • • •
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> In sum, it took the government nearly 50 years before it thought to treat the receipt of an interest-free loan as a taxable event, and over 20 years of case law has since held to the opposite view.... In reversing the decision of the trial judge, we do not disparage his economic analysis of the transaction. Rather, we follow the *Dean* holding because it represents a well-entrenched interpretation that has logical support.

708 F.2d at 663, 664. Petitioners respectfully submit the same conclusion is fully warranted in the gift tax area, and the same result should follow.

In order to create even an illusion that the "time-value" concept can be forced within the statutory language of a "transfer of property by gift," the IRS must adopt the untenable position that term and demand loans may be equated for gift tax purposes. The IRS notes that the regulations provide that a gratuitous conveyance of a term estate constitutes a taxable gift of the value of the estate. Brief for the Respondent at 16. This is

hardly surprising: a discrete "transfer" has occurred on a specific date, and it may readily be valued and taxed as of that date.[6]

Such a result is no authority for imposition of tax in this case, however. Here the only remotely comparable events were the making of the interest-free loans, which involved discrete transfers of money in return for demand promissory notes of substantially equal value. The IRS admits that the interest-free loans "were not gifts of the sums transferred because [the borrower] agreed to repay those amounts on demand." Brief for the Respondent at 13. Nor does the IRS claim that a taxable gift even of a "right to use" occurred at the times the loans were made, for that "right" could be terminated at any moment and obviously was incapable of valuation at the dates of the loans.

The IRS thus does not seek to base a tax on this actual transfer, but only on theoretical "transfers" which purportedly occur continuously over the duration of the demand loan. It therefore seeks to equate the making of a term loan, which involves a real transfer of property, with the moment-by-moment continuance of an existing demand loan — which is nothing more than a failure to terminate an existing possibility of economic benefit on the part of the borrower. Unless the statutory term is simply to be ignored and the absence of any actual "transfer of property by gift" deemed irrelevant, the attempt of the IRS to equate these transactions must be rejected.[7]

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[6]Petitioners do not concede that term loans of money are proper subjects of gift taxation under current law. This issue is not before the Court in this case, however, in view of the factual findings of the Tax Court which are not here disputed.

[7]One difference in the tax treatment of term and demand loans, even if the claim of the IRS were accepted, would be obvious. A term loan would be valued and taxed as of the date made, and the amount of the gift would be subject to the $10,000 annual exclusion in that year. Under the theory of the IRS, demand loans would result in continuous "gifts" over the term of the loan and thus could be subject to multiple annual exclusions if the loan lasted for several years. Thus, the tax treatment of term and demand loans would not be equal even if the IRS contention were accepted.

Perhaps the clearest evidence that the "time-value" theory of the IRS is not currently a part of the gift tax law comes from the Treasury itself. On June 24, 1983, Robert G. Woodward, Acting Tax Legislative Counsel of the Department of the Treasury, appeared before the IRS Oversight Subcommittee of the Senate Finance Committee. In outlining areas of possible legislative action, Mr. Woodward stated:

> The high interest rates and inflation that we have experienced in recent years bring into question the economic assumptions that underlie certain provisions of the Internal Revenue Code. These high rates have resulted in a material increase in the "time value of money"....In many respects, the Code ignores time value of money concepts....[W]e believe the time has come for a fundamental reexamination of several provisions of the Code that do not properly take time value of money concepts into account.

Proposed Amendments to the Internal Revenue Code of 1954, as Amended: Hearings before the Subcommittee on Oversight of the Internal Revenue Service of the Senate Committee on Finance, 98th Cong., 1st Sess. (1983) (Statement of Robert G. Woodward), *reprinted in* Daily Tax Report (BNA) No. 123, J-4, J-7 (June 24, 1983) (hereinafter cited as *Woodward*). Mr. Woodward then set forth for the Subcommittee several such areas, including "Interest-Free Loans." After referring briefly to this case and *Crown v. Commissioner*, 585 F.2d 234 (7th Cir. 1978), he concluded:

> In our view, interest-free loans...should be treated for tax purposes as if interest actually had been paid at a market rate and rebated to the [borrower].[8] We recognize the need for a *de minimis* type exception in this area as well.

Woodward at J-10.

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[8]The language set forth in the bracketed portion of the quotation is made with the authorization of Mr. Woodward. Telephone conversation with Robert G. Woodward (October 14, 1983). The Court may wish to note that the Treasury proposal would require the lender to pay income tax as well as gift tax on the imputed receipt and "rebate" of interest.

Thus, at virtually the same time the IRS was preparing to argue to this Court that its "time-value" theory was embodied in the 1932 gift tax law and that no need for legislative action exists, the Treasury Department was frankly acknowledging the opposite to the United States Senate. In this respect, the statements of the Government before the Senate plainly belie its words to this Court. The IRS should now candidly acknowledge to this Court that it seeks to change the gift tax law and should attempt to do so in the Congress, which is the only proper forum for that effort. *See United States v. Byrum*, 408 U.S. 125, 135 (1972). If the IRS persists in attempting to import its "time-value" concept into the 1932 gift tax law, however, this Court should squarely reject that invitation to judicial legislation.

II. THE SERIOUS ADVERSE CONSEQUENCES OF ANY JUDICIAL ADOPTION OF THE THEORY OF THE IRS CANNOT EFFECTIVELY BE DENIED.

The IRS attempts in its Brief to greatly minimize or ignore the difficulties and anomalies which would result from any judicial adoption of its "time-value" theory in this case. In its view, many interest-free demand loans are of doubtful economic substance,[9] and a need exists to impose a gift tax to prevent possible abuses. Rather than employ the tools which it now has

[9]Brief for the Respondent at 25. The Dickmans vigorously dispute the general and unsupported assertions of the IRS with respect to alleged distinctions between demand loans in "arm's length" business and family contexts. In claiming that the lender typically reacts to deterioration of the borrower's financial position in opposite ways in the differing contexts — with the banker demanding payment while the family member does not do so and may extend further loans — the IRS betrays a lack of experience in the practical world of banking. Bankers quite commonly extend or increase loans or lines of credit during difficult periods for their customers, seek repayment only when the customer has "sufficient funds available," and allow such customers credit for "indefinite, extended periods" — all supposed characteristics only of intrafamily loans. *See* Brief for the Respondent at 25-27.

to identify and deal with such instances, however, the IRS seeks from this Court a blanket judicial ruling which would impose tax equally on those who engage in sham loans to evade taxation and those — like the Dickmans — who made *bona fide* loans in a family business context with neither the purpose nor effect of tax avoidance. The Court should not reward this overzealous effort on the part of the IRS, and should leave to the Congress the fashioning of a comprehensive remedy for any problem which may exist.

As noted by Mr. Woodward in his recent statement to the Senate, the Government is seriously — and, Petitioners submit, justly — concerned that some interest-free demand loans may be matters of form rather than substance:

> We believe many of the alleged interest-free loans used by taxpayers to attempt to shift income to lower-bracket taxpayers are not true loans. For example, there would be little economic substance to a non-recourse loan by Father to Son with the loan proceeds being invested in stock that is pledged as security for the loan.

Woodward at J-9, J-10. Mr. Woodward, unlike the IRS in its Brief, indicated by these comments a recognition that such instances of abuse may be attacked under long-recognized doctrines of tax law. For example, the IRS plainly has the power to demonstrate that what purports to be a demand loan is in fact a gift, and to tax it as such.

> The question always is whether the transaction under scrutiny is in fact what it appears to be in form; a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance.

Chisholm v. Commissioner, 79 F.2d 14, 15 (2d Cir. 1935), *cert.*

denied, 296 U.S. 641 (1935) (Hand, L., J.). *See also Gregory v. Helvering*, 293 U.S. 465 (1935); Rev. Rul. 77-299, 1977-2 C.B. 343.

What the IRS seeks in this case, then, is not a tool necessary to effectively tax gifts that are in the guise of loans, or income earned in the name of a low-bracket taxpayer but in fact earned and controlled by a high-bracket taxpayer.[10] Such tools exist, and the loans at issue here plainly fall in neither category. The IRS instead seeks a broad judicial adoption of its "time-value" concept as a part of the gift tax law, one which would give it *carte blanche* to impose tax retroactively on those who have acted in bad faith and those who have acted in good faith alike.

In determining whether this result is appropriate, the Court may wish to consider still another example of the sweep of the principle for which the IRS contends.[11] Mrs. Hanora C. Dorn, a resident of McCormick, South Carolina, was a small (0.5 percent) shareholder in the only bank in her county. Her adult daughter owned 26 percent of the bank's stock and an unrelated family owned 73.5 percent of the shares. For several years prior to her death in 1980, Mrs. Dorn maintained a sizable checking account in the bank, which bore no interest. After her death, the

[10]The claim of the IRS that adoption of its "time-value" theory is necessary to preserve the efficacy of the statutory provisions enacted after this Court's decision in *Helvering v. Clifford*, 309 U.S. 331 (1940), also is without force. *See* I.R.C. § 671 *et seq.* The *Clifford* provisions are concerned with the taxation of income actually earned by short-term trusts, not the theoretical interest income which the IRS proposes to use to value alleged "gifts" in this case. Moreover, as noted by the Court in *Wells Fargo Bank v. Cory*, the *Clifford* trust and demand loan contexts are not comparable in terms of the control retained by the grantor or lender:

> [T] beneficiary of a trust cannot reach the corpus so the funds remain intact: in the loan situation, a borrower can consume the funds and the lender is left with a promise to repay.

110 Cal. App. 3d at 250, 167 Cal. Rptr. at 783.

[11]All facts in this example are from a Brief submitted to Atlanta Appeals Office, IRS, in *Estate of Hanora Dorn* on June 30, 1983, by the attorney for the Dorn Estate, Johnnie M. Walters, former Commissioner of Internal Revenue.

IRS Estate Tax Attorney sought to increase the amount of her gross estate by the sum of $139,546.76, claiming that to be the value to the bank of the use of Mrs. Dorn's money in her account over the several years prior to her death. The IRS attorney stated as follows in the Examination Report:

> Pursuant to I.R.C. Section 2035 and *Dickman v. Comm*. . . ., the value of the right to use that sum (on the part of the bank and its shareholders) is equivalent to a gift and as such must be included in decedent's gross estate under I.R.C. Section 2035.

Thus, Mrs. Dorn was deemed by the IRS in effect to have made a "gift" to an unrelated family of 73.5 percent of $139,546.76, or over $100,000, merely by keeping her money in a checking account in the only bank in her county.

Any judicial adoption of the contention of the IRS in this case inevitably would give rise to injustices and unexpected results in individual cases like that of Mrs. Dorn[12] and in a multitude of others which neither the parties nor this Court can now foresee. As stated by the Federal Circuit Court of Appeals in *Hardee*:

> **The task of fleshing out the principle, if valid, that interest-free loans are a benefit which should be taxed as income, involves the framing of meticulous and balanced rules. The judicial legislation proposed by the United States and to a less extent by the court below, would represent use of a meat axe where the appropriate instrument would be a scalpel. The authorities cited represent a so-far unanimous refusal by the judiciary to grasp the handle tendered, and we decline to break the unanimity.**
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> **708 F.2d at 667.**

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[12]The executors of the Dorn Estate, both over eighty years old, agreed to pay in settlement a portion of the tax claimed by the IRS in order to avoid protracted and costly litigation. Telephone conversation with Johnnie M. Walters, attorney for the Dorn Estate (October 10, 1983).

The IRS in its zeal again denies the need for a "scalpel" in this case, and urges this Court to do so as well. The dangers of an *ad hoc* venture into this area, however, are serious ones which cannot be dismissed in this cavalier fashion. Indeed, the experience of Great Britain with the very issue involved in this case both illustrates the difficulties of devising workable rules in this area, and demonstrates that even a careful legislative effort may well be futile, or at least productive of more difficulties than it solves.

In its Finance Act of 1975, Great Britain repealed its estate duty and replaced it with a capital transfer tax which applied to all "transfers of value" — any transfer which reduced the value of the transferor's estate — whether made during a person's lifetime or at death. Included in the capital transfers which Parliament sought to subject to tax under Section 41 of that Act were what it termed "free loans": "the use of money or other property without consideration in money or money's worth or for a consideration less than could reasonably be expected in such a transaction." Finance Act, 1975, Section 41 (see Appendix at A-1, attached). The General Notes to Section 41 recognized that this section was to have "the widest possible ambit and will cover such things as interest free loans to companies or the letting of property to a relative rent free." However, the same General Notes went on to state that "the Government has . . . undertaken to consider the effect of the section where it is considered it might operate harshly . . .", and the implementation of the new provisions was deferred for that purpose.

Before the effective date of April 6, 1976, the Government determined that more detailed provisions, which distinguished, *inter alia*, between loans which the lender could terminate at any time (demand loans) and loans which could not be terminated for a fixed or for a minimum period (term loans), were

necessary. Parliament therefore replaced Section 41 of the 1975 Act with Sections 115 and 116 of the Finance Act of 1976 (see Appendix A-2 - A-6, attached). In these detailed statutes, Parliament demonstrated its recognition of the difficulty of subjecting such "free loans" to a gift tax by providing a series of special exemptions which attempted to take into consideration the variety of possible relationships between the lender and borrower, as well as the duration of the loan. The amount of the deemed gift was also reduced by the income tax which would have been paid by the lender if the amount of the gift had been included in the lender's taxable income at the lender's highest applicable rate. Five years later, however, the experiment was a failure. In 1981, Sections 115 and 116 were repealed. The repealing statute includes the following General Note:

> The free loan provisions are abolished by this provision. There was no case where a charge had ever been made under them.

Finance Act, 1981, Section 106. (see Appendix A-6 - A-7 attached). *This statement was verified during debate on repeal: Hearings Before Standing Committee E of the House of Commons* 799-800 (1981) (see Appendix A-7 - A-9 attached).

The IRS nevertheless professes to see no potential difficulties which might be created by judicial adoption of its taxation theory in this case. For example, it claims that the practical problems of attempting to tax the multitude of instances of intra-family sharing are "largely if not entirely illusory." Brief for Respondent at 34. It seeks to demonstrate this by emphasizing the large size of a loan that would result in elimination of the entire lifetime unified gift and estate tax credit in a single year. In so doing, the IRS stubbornly refuses to acknowledge the reality that many citizens regularly have made outright annual gifts of the statutory exclusion amount, and long have acted on the

common understanding that a loan is not a "gift."[13] It is these people — or the beneficiaries of their estates upon their deaths — who would find for the first time that the long-outstanding loan to finance a son's first business endeavor or a daughter's vacation home quietly ate away the unified tax credit. It is these families who would find themselves with an unexpected tax bill, including interest on gift tax that went unpaid, and with no liquid assets to pay it.[14]

The IRS may have little concern with such practical effects of its position in this case. It has shown little concern for the fact

[13]The IRS does not deny that judicial adoption of its theory would require all citizens who make annual gifts of at least $10,000, the statutory exclusion amount, to assume the legal burden of identifying, valuing, and reporting each further loan or permissive use of property within a family, however "insignificant" in the view of the IRS.

[14]One such instance is suggested by the following example: A farmer owns farmland worth $1 million and other assets worth $500,000. He retires in 1976 but allows his grandson to farm the land thereafter, and seeks no payment from the grandson. The farmer and the grandson both understand that the farmer has the right to regain possession of the land on demand. The grandson farms the land for 20 years until the farmer dies, leaving an estate which has not changed in value. A daughter of the farmer, who has depended upon him for financial support, is his sole beneficiary.

The estate tax examiner agrees that the value of the gross estate is $1,500,000, but determines that "adjusted taxable gifts" under Section 2001(b)(1)(B) amounted to $2 million. These "gifts" are calculated by multiplying what the IRS finds to be the fair rental value of the farmland of $110,000 per year (less the $10,000 annual exclusion under Section 2503(b)) times the 20 years during which the grandson had the use of the land. As these "gifts" were unreported, a gift tax deficiency of $588,000 would be assessed and interest of $697,531.68 would be payable (ignoring the new compound interest rules of Section 6622). The resulting liability of $1,285,531.68 would be followed as a deduction under Section 2053, resulting in a taxable estate of $214,468.32 and an estate tax, after including the adjusted taxable gifts, of $105,089.51.

Under these facts, the doctrine proposed by the IRS would cause the farmer's failure to extract from his grandson cash payment for use of his land to result in a reduction of his estate from $1.5 million to a net amount of $109,378.90, after estate and gift taxes and deficiency interest — a 92.7% reduction of his gross estate. The farm would be sold to pay the taxes, but would prove insufficient; most of the farmer's other assets would have to be sold as well. His daughter, for whom he intended to provide a comfortable life, would unexpectedly be left with relatively little.

that a loan to finance a child's college tuition would be subject to gift tax under its theory, while an outright gift of the same tuition would not. See Brief for the Petitioners at 36. It also has shown that it has little concern as to whether it determines the "value" of the "right to use money" by radically different methods in the cases of different citizens, or whether retroactive imposition of gift taxes based on its theory would be unfair to many taxpayers.[18]

These are, however, precisely the types of specific considerations which would be presented to Congress in connection with its consideration of any proposed legislation in this area. More importantly, it can safely be predicted that Congress would reasonably deal with such specific issues in any law which it enacted. The reason for this is simple, and it is one which is at the heart of our Constitution's insistence that laws be made only by the Legislative Branch: the people to whom those issues matter help elect their representatives in Congress, they have access to them, and they can communicate to those representatives the concrete effects of proposed legislation upon their lives.

The IRS has avoided for years the presentation to Congress of the economic and tax policy arguments which it now asks this Court to adopt. Now — at the very time when the Treasury appears to be preparing to make that presentation — the IRS seeks a wholesale judicial adoption of its "time-value" concept by this Court, one which would impose substantial gift taxes retroactively on citizens who have made *bona fide* loans with no tax motivation whatsoever. The members of the Dickman family, for themselves and on behalf of the many affected citizens who

[18]The IRS also dismisses the problems of valuation, suggesting that they can easily be resolved "through the testimony of a banker who is familiar with prevailing interest rates." Brief for the Respondent at 37. To do so, it must simply ignore the difficulties of selecting the rates that should be applicable in an intra-family demand loan context, the disparate methods used and results reached by the IRS itself in this area, and the many difficulties of valuing permissive use within the family of property other than money.

have no voice before this Court, respectfully ask the Court to reject this request and to place this matter squarely in the legislative realm in which it belongs.

Accordingly, the judgment of the Court of Appeals should be reversed, and the judgment of the Tax Court affirmed.

Respectfully submitted,

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APPENDIX

(British Capital Transfer Tax)

Statutes are from "Finance Act 1975", "Finance Act 1976" and "Finance Act 1981", all published by Her Majesty's Stationery Office, London. The record of debate in Standing Committee E is from Hansard, the official publication of Parliamentary debates.

1975 ACT:

Free loans etc.

41.—(1) Where a person, otherwise than in a transaction at arm's length between persons not connected with each other, allows another the use of money or other property without consideration in money or money's worth or for a consideration less than could reasonably be expected in such a transaction, he shall be treated as making a transfer of value in every chargeable period in which he allows that use; and—

(a) the value transferred thereby shall be the difference between the amount of the consideration (if any) for that period and that of the consideration that might be so expected; and
(b) the transfer shall be treated as being made at the end of the chargeable period or, if earlier, at the time when that use comes to an end; and
(c) the transfer shall be treated as made out of the transferor's income.

(2) In this section "chargeable period," in relation to any use, means the period beginning when the use is begun and ending with 5th April next following, and every subsequent period of twelve months ending with 5th April, but no period beginning before 6th April 1976 shall be a chargeable period.

General Note

This section creates a transfer of value when assets are made available to a person when that person does not pay the market price for their use. The section has the widest possible ambit and will cover such things as interest free loans to companies or the letting of property to a relative rent free. The Government has however undertaken to consider the effect of the section where it is considered it might operate harshly, *e.g.* loans to companies, or by one partner to another (see Hansard, Vol. 887, 1944). This is why the coming into effect of the section is postponed until April 6, 1976.

Note that the transfer is treated as made out of the transferor's income thus enabling the exemption in Sched. 5, para. 5 to be obtained in appropriate circumstances. This paragraph would be less likely to provide exemption if the interest fee loan etc. were made for only one year than if it were made for a number of years.

1976 ACT: *Loans*

Free loans etc.

115.—(1) Where an individual ("the lender") allows another person ("the borrower") the use of money or other property in any year, then, subject to the provisions of this section and section 116 below, the lender shall be treated as making a disposition as a result of which the value of his estate is reduced by the amount (if any) by which any consideration for the use falls short of the cost to him of allowing it (determined in accordance with section 116 below).

(2) The disposition under subsection (1) above shall be treated as made at the end of the year or, if earlier, at the time when the use comes to an end.

(3) Where the use of the property is allowed for a period specified in advance, or where in any other case the lender has no right to terminate the use immediately after it begins, subsection (1) above shall not apply in relation to use before the expiration of the specified period or, as the case may be, before the earliest time when the lender could terminate the use if he exercised his right to do so at the earliest opportunity.

(4) Subsection (1) above shall not apply in relation to any use of property allowed to the borrower at a time when it is mainly used by the lender or the lender's spouse.

(5) Subsection (1) above shall not apply in relation to the use of property for a period which is less than twelve months unless that period falls within a period of twenty-four months during which the lender allows the borrower the use of that property or similar property for periods which amount in aggregate to twelve months or more; and in calculating that aggregate no account shall be taken of—

(a) use to which, by virtue of subsection (3) or (4) above, subsection (1) does not apply, or

(b) use to which (apart from this subsection) subsection (1) above does apply, if the disposition under that subsection is not a transfer of value.

(6) Subsection (1) above shall not apply in relation to the use of property where the borrower is a body corporate if—

(a) it is not a close company; or
(b) not less than 90 per cent in nominal value of its issued ordinary shares are shares to which the lender or his spouse is beneficially entitled; or
(c) it is not an investment company and either—

(i) the lender or his spouse is a participator in the company or its holding company or has been such a participator at any time during the year or either of the two preceding years; or

(ii) the lender's spouse died during the year or either of the two preceding years and was at any time during the three years ending with the year in which he died a participator in the company or its holding company.

(7) Subsection (1) above shall not apply in relation to the use of property where the borrower is a firm if—

(a) the lender or his spouse is a partner or has been a partner at any time during the year or either of the two preceding years; or
(b) the lender's spouse died during the year or either of the two preceding years and was a partner at any time during the three years ending with the year in which he died.

(8) Subsection (1) above shall not apply in relation to a loan in respect of which any person is chargeable to income tax under Schedule E by virtue of section 66 (1) above.

(9) For the purposes of this section an individual who makes a revocable gift of any property to another person shall, so long as the gift continues revocable, be taken to allow him the use of that property.

(10) In this section—

"close company" and "participator" have the same

meanings as in section 39 of the Finance Act 1975;
"firm" has the same meaning as in the Partnership Act 1890;
"holding company" has the same meaning as in section 154 of the Companies Act 1948;
"investment company" means a company falling within paragraph (a) of paragraph 16 (3) of Schedule 4 to the Finance Act 1975 and not falling also within paragraph (b) or (c) of that paragraph;
"ordinary shares" has the same meaning as in paragraph 13 of that Schedule;
"year" means period of twelve months beginning with 6th April.

(11) This section has effect, in place of section 41 of the Finance Act 1975, in relation to the year beginning 6th April 1976 and subsequent years.

General Note

This provision imposes a charge to c.t.t. upon the cost to a lender of making his property available free of charge to a borrower. This wholly replaces F.A. 1975, s. 41, which never took effect, so that "loans" are only chargeable to c.t.t. after April 5, 1976.

For a charge to arise under this provision the following conditions must be satisfied, namely:

(i) The loan must be made by an individual—so that a loan by a company or trust will not be caught by this charging provision.

(ii) That individual must allow another person (so this may include a company or trustees) the use of his money or property whilst retaining a right to recover that money or property. The loan of the money or property for a fixed period thereby giving the borrower a right to retain it as against the lender will not come within s. 115 until the earliest time at which the lender could have recovered the money or property either through the expiry of time or the exercise of a right. Such a loan for a fixed period, or subject to the exercise of a notice of revocation, will, however, be chargeable as a transfer of value under F.A. 1975, s. 20. It should be noted that a revocable gift will be treated as the loan of money or property for these purposes.

(iii) The loan of money on property is not one of the following:

(a) exempt under one of the general exemptions, *e.g.* normal expenditure exemption applied by virtue of s. 117 of this Act (see below);
(b) made to a borrower but used "mainly" by the lender or lender's spouse;
(c) made to a public company;
(d) made to a close company in which the lender or the lender's spouse holds, beneficially, not less than 90 per cent, in nominal value of its issued ordinary shares;
(e) made to a close company which is not an investment company and

in which company (or the holding company) the lender is, or was at any time in the year in respect of which the charge arises or the preceding two years, a participator. Alternatively, this will equally apply if instead of the lender it is the lender's spouse that is the participator in the same circumstances or if the spouse has died during that two year period was a participator at any time during the three years ending with the year in which the spouse died;

(f) made to a firm (defined by the Partnership Act 1890, s. 4) in which the lender or lender's spouse is, or was at any time as specified in (e) above, a partner;

(g) a loan resulting in any person being chargeable to income tax under Schedule E by reason of s. 66 (1) of this Act (see above).

When a loan of money on property has been made which satisfies these requirements then a disposition is treated as having been made either at the end of the year (April 5) or at the time when the use came to an end during the year, whichever is appropriate. The reduction in the lender's estate is taken to be the difference between the consideration given by the borrower and the cost of the loan to the lender determined in accordance with s. 116.

Free loans etc.: value transferred

116.—(1) The cost to the lender of allowing the use of money or land shall be taken to be equal to the consideration which might be expected in a transaction on the same terms as those on which the use is allowed (apart from terms as to consideration) made at arm's length between persons not connected with each other.

(2) The cost to the lender of allowing the use of property other than money or land shall be taken to be equal to the aggregate of—

(a) the annual value of the use of the property or, if the use does not continue throughout the year, a proportionate part of that annual value, and

(b) any expense incurred by the lender in connection with property during the year or, if the use does not continue throughout the year, a proportionate part of that expense, but excluding expense incurred in the acquisition or production of the property and excluding any hire charges;

except that if the property is hired by the lender and the annual amount of the hire charges is greater than the annual value of the use of the property, paragraph (a) above shall have effect as

if it referred to that annual amount instead of to that annual value.

(3) If the property is money or land, the amount arrived at under section 115 (1) above shall be reduced by the income tax which would be chargeable in respect of that amount (after taking account in the case of land of any deductions which might be made for the purposes of Schedule A) if it were the highest part of the lender's total income; and in calculating that income there shall be disregarded any such sum as is mentioned in paragraphs (a) to (c) of section 529 of the Taxes Act.

General Note

The amount on which a charge under s. 115 is made will be in the case of land and money the income forgone by the lender net of income tax at the lender's top marginal rate. In the case of other property, principally wasting assets, the amount will be the annual value of the property (*i.e.* its depreciation) plus any expenses on the property borne by the lender.

Subss. (1) *and* (3). These deal with the loan of money or land. The amount upon which the c.t.t. charge is made will be the consideration that would have been received from an arrangement for such use made between unconnected persons at arm's length reduced by the consideration actually received by the lender. There is a further reduction of the income tax that would have been paid by the lender had he received the full consideration and treating this as the highest part of the lender's income. The following payments are to be disregarded when determining the lender's liability to income tax, that is, (a) any payments received upon retirement or the removal from an office or employment and assessable under I.C.T.A. 1970, s. 187; (b) any gains from insurance policies assessable under I.C.T.A. 1970, s. 399; (c) any sum chargeable under I.C.T.A. 1970, Sched. 3, para. 2 (such as premiums on lease and payments concerning sale of land with right to reconveyance).

Subs. (2). This concerns the loan of property other than money or land. In such a case the amount chargeable is the sum of the annual value of the property and any expenses incurred by the lender in respect of the property (disregarding the expenses of purchasing, manufacturing or hiring the property).

The cost to the lender of hiring the property will be substituted for the annual value of the property if that cost is greater than the property's annual value.

1981 ACT:

Free loans

106.—(1) Sections 115 and 116 of the Finance Act 1976 (free loans etc.) shall cease to have effect.

(2) This section applies where the disposition under subsection (1) of section 115 would in accordance with subsection (2) of that section be treated as made on or after 6th April 1981.

General Note

The free loan provisions are abolished by this provision, there was no case where a charge had ever been made under them.

Clause 100

Free loans (Debate - Standing Committee E)

Question proposed. That the clause stand part of the Bill.

Mr. Robert Sheldon: The clause covers the free loans provision. Under the existing legislation, capital transfer tax was charged essentially on the benefits of those interests that were concerned. Clearly, a loan certainly confers a very large advantage on its beneficiary. It is, in effect, a transfer of capital. If one person gives another the use of a substantial sum for a period of years, he is, in effect, making a transfer of money from himself to the beneficiary—from the donor to the donee—and it is right that capital transfer tax be charged on it.

This is a relieving provision which says that for some reason capital transfer tax will not be charged on this transfer of what is, in effect, money passing from one person to another. I would like to hear the honourable and learned Gentleman's justification. I know that the amounts of revenue are not likely to be large, but I should be obliged if the honourable and learned Gentleman would give me an illustration or assessment of this. I do not see why, for the reasons that I have given on many other clauses, this particular relieving provision should be in a Bill which places so many burdens of the kind that we have already discussed.

Mr. Peter Rees: It is almost with a sense of nostalgia that I rise to respond to the right honourable Gentleman. It carries me, as it no doubt carries him, back to the debates we had in this same Committee Room some six years ago. He will remember that, as capital transfer tax was first devised, there was to be a blanket charge to capital transfer tax for free loans. Then a

wealth of instances was brought to his and his right honourable Friend's, attention by my hon. Friends and even perhaps myself, showing how hard this would bear on people, particularly in the business sector.

It was in a gracious response to those arguments that sections 115 and 116 were introduced. Though they perpetuated the charge for free loans—the loans had hardly been introduced so perhaps "perpetuated" is a slightly maladroit description—none the less they hedged it round with considerable exemption. For instance, there was an exemption for any period during which the property concerned was mainly used by the lender or his spouse. Secondly, loans where the property or similar property was made available for fewer than 12 months within a 24-month period were exempted. Thirdly, certain loans to companies and partnerships had particular importance for exemption, and finally, loans which were chargeable to income tax under schedule E were exempted.

I am happy to pay tribute, over the years, to the open-mindedness of the right honourable Gentleman and his right honourable Friend's on that occasion. The exemptions were worked into what was otherwise a rather unattractive piece of legislation.

The consequence of this is that in practice the free loan provisions have never had to be invoked by the capital taxes office. We felt that perhaps they were otiose, spent, and were no longer serving a useful purpose. They were of some complication and might have involved some administrative trouble, both for personal representatives or trustees or for the Inland Revenue. Therefore, we felt that they could be legitimately swept off the statute book. I am happy to reassure the right honourable Gentleman that, on the past experience of the capital taxes office, there will be a negligible loss of revenue.

I hope that the right honourable Gentleman, looking back with me with nostalgia to our previous debates, will feel that perhaps these sections can now be swept away.

Mr. Robert Sheldon: The Minister of State says that the

provisions were never invoked. Does he mean by that that there has never been a case where a charge has been made here?

Mr. Rees: So I am credibly informed.

Finally, let me reassure the right honourable Gentleman that the asset that may or may not be loaned will, by definition, remain the property of the transferor and so ought to be swept up in a charge to capital transfer tax on his death or on any subsequent transfer. Therefore, I hope that the right honourable Gentleman will be reasonably reassured by what I have said and that the Committee will feel able to support the clause.

Question put and agreed to.

Clause 100 ordered to stand part of the Bill.

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